

legislative history makes clear that the certification requirements are maximum requirements.¹⁴¹ The certification provision does not require any finding prior to certification that there not effective competition, and certainly does not require the franchising authority to make such a determination. In fact, that determination must be made by the FCC.¹⁴²

Contrary to the industry's suggestion, the FCC must determine within 30 days that a franchising authority is not qualified to regulate, or the certification will be deemed effective. § 623(a)(4), 106 Stat. at 1464-65. The language of the Act is unambiguous. The FCC must notify the franchising authority and give it an opportunity to respond before that 30-day period expires. This does not allow time for extensive evidentiary proceedings to allow the operator to challenge certification, and it plainly makes no provisions for extensions of the consideration period by the FCC.¹⁴³ The operator has those opportunities after certification has been granted. § 623(a)(5), 106 Stat. at 1465.

¹⁴¹ House Report at 81 (expressing the intent that the FCC should certify any franchising authority that meets the requirements set out in the certification provision).

¹⁴² Id. at 81.

¹⁴³ See, e.g., NCTA comments at 65-67 (operators should be able to challenge certification and then have 30 days to present evidence in support, then FCC will have another 30 days after reviewing the evidence to reach a decision).

**D. The Bill Itemization Proposed by the
Industry Cannot Be Severed with the Statute**

**1. The FCC should not allow operators to
treat itemized amounts as an add-on to bills**

The Commission proposed that any itemization by the cable operator of franchise fees, PEG channel costs, or other governmental transaction costs must be made part of the total charge for cable service and not separately billed.¹⁴⁴ The Commission's approach is correct.

In its franchise agreement, a cable operator undertakes to compensate the local community for the operator's permanent occupation of the community's public rights of way, just as it undertakes to provide a certain number of channels and quality of service. This compensation is normally provided in the form of franchise fees and other community services. These expenses are not taxes added onto the cost of service. Rather, they are part of the cable operator's cost of doing business, like the rents it pays for office space or headend sites, and the salaries of its employees. These expenses are recovered in the operator's retail price. It would thus be misleading to permit a cable operator to treat the franchise fee as an add-on over and above the retail price it charges subscribers.

The legislative history of the Act makes it clear that the franchise fee must be itemized as part of the operator's total bill. The House Report specifically provides that the operator

¹⁴⁴ NPRM at ¶ 175.

"shall not identify cost [sic] itemized pursuant to section (b)(4) as separate costs over and beyond the amount the cable operator charges a subscriber for cable service," and adds a detailed example:

. . . a cable operator might itemize pursuant to section (b)(4) a \$1.50 per month charge to account for a five percent franchise fee obligation. If a cable operator charges \$30 per month for basic cable service, the \$1.50 itemized charge shall be included in such amount; the cable operator cannot provide the cable subscriber a basic cable bill for \$28.50, with a \$1.50 additional charge added as a franchise fee. Thus, the bill would show a total charge of \$30, but the cable operator would have the right to include in a legend a statement that the \$30 basic cable service rate includes a five percent franchise fee, which amounts to \$1.50.¹⁴⁵

The Act thus envisions a subscriber bill that will look like the following:

Basic Service	A
<u>Expanded Basic</u>	<u>B</u>
Total Cable Service	C *

*5% of the total bill is paid to your City as a franchise fee.

Several members of the industry, however, argue that the Commission should authorize a bill of exactly the sort forbidden in the passage quoted above:¹⁴⁶

Basic Service	A
<u>Expanded Basic</u>	<u>B</u>
Total Cable Service	C
<u>+ Franchise Fee</u>	<u>5% of C</u>
Total You Pay	D

¹⁴⁵ House Report at 86. The reference is to Section 623(b)(4), which contained the subscriber itemization provision in the House version of the Act.

¹⁴⁶ See, e.g., Comments of Continental Cablevision at 79.

In other words, franchise fees are treated as an "add-on" to rates. Three serious problems result from this approach.

a. Inaccurate franchise fee payments. Franchise fees are generally calculated as a percentage of gross revenues.¹⁴⁷ The Coalition is aware of instances, however, where cable operators have improperly sought to calculate that percentage only after deducting the franchise fee itself from those revenues (as illustrated in the second table above), as if the franchise fee were a tax collected on behalf of the community rather than fair compensation for use of the community's resources. Whether itemized or not, the franchise fee is an expense, and it may no more be deducted from "gross revenues" than any other expense the operator incurs in its business.

b. Inaccurate rate regulation. Allowing operators to treat the franchise fee as an add-on to their rates would open the door to potential rate regulation evasions. To provide the simplest example, suppose it were determined that the appropriate rates for basic service in a community were \$8.00, including PEG costs, franchise fees, and other charges.¹⁴⁸ An operator should not then be permitted to use the itemization provision to charge the \$8.00, and then itemize already accounted-for costs as a way to raise rates to \$8.40. This would

¹⁴⁷ The Cable Act's ceiling on franchise fees is stated in terms of a percentage of gross revenues. Cable Act § 622(b), 47 U.S.C. § 542(b).

¹⁴⁸ House Report at 82-83.

constitute the sort of evasion Congress has instructed the Commission to prevent.¹⁴⁹

c. Misleading presentation to consumers. As noted above, the franchise fee is not a levy on subscribers collected by the cable operator. Rather, it is an expense to the operator that is recovered in the retail price for cable service. To pretend otherwise is deceptive to consumers, who require accurate price information.

An example of this last problem is arising in Miami Valley, Ohio, in an area served by Continental Cablevision, Inc. ("Continental"), one of MSOs that most strenuously supports "add-on" itemization.¹⁵⁰ Relevant correspondence is appended as Reply Attachment 2. In Miami Valley, Continental wishes to display the franchise fee as if it were charged by the franchising authority to the subscriber, on top of a lower, supposedly "uniform," rate charged by Continental. Continental (unlike some operators) recognizes it must pay a franchise fee on the total amount paid by the subscriber. But, to create the impression that the fee is added on top of a lower, uniform rate, Continental must represent the franchise fee as a percentage of that hypothetical lower amount.¹⁵¹ Thus, in the name of clarity

¹⁴⁹ See § 623(h), 106 Stat. at 1470.

¹⁵⁰ See Continental Comments at 75-79.

¹⁵¹ The following example is adapted from the figures in Continental's January 11, 1993 letter (Reply Attachment 2) and the format in Continental Comments at 79:

Continental's actual payment

Continental's misleading bill

and consumer awareness, Continental actually seeks to include on its bills an entirely imaginary basic cable rate and an equally imaginary franchise fee amount.¹⁵²

Moreover, Continental claims that it needs to exclude franchise fees from its price so that it can advertise "uniform" rates.¹⁵³ If Continental's rates are not uniform in fact, however, it would be odd to argue that the rules must be designed so that Continental can disguise the true price it charges.¹⁵⁴

Continental's arguments in its comments in support of add-on itemization certainly do not justify this inaccurate and misleading presentation. For example, Continental's comments speak repeatedly of "burying" or "hiding" franchise fee amounts.¹⁵⁵ This objection is nonsensical. As illustrated above, the franchise fee payment can be shown accurately on a bill without adopting the approach Continental urges. Continental's arguments about the "plain language of the statute"

Charge to subscriber	23.63	Cable Service	22.50
includes		Franchise Fee	1.13
5% franchise fee	1.18	Total You Pay	23.63

¹⁵² Reply Attachment 2, p. 2, ¶ 2 ("... the amount which will be itemized on the invoice, which is fractionally less than the amount we will be paying to your community").

The problem of misleading price quotations based on improper handling of franchise fees was recognized by the Department of Justice of the State of Oregon as far back as 1988. See Reply Attachment 2 (correspondence).

¹⁵³ Continental Comments at 77-78.

¹⁵⁴ Before the projected rate change, Continental charged uniform rates in the area, notwithstanding differences in franchise fee rates.

¹⁵⁵ See, e.g., Continental Comments at 75, 77, 79.

and the need for "openness in billing" miss the point.¹⁵⁶

Itemizing franchise fees as an "add-on" is misrepresentation, not candor.

Continental's reference to itemization of costs on telephone and electric bills is still wider of the mark.¹⁵⁷ It is, to begin with, inconsistent with Continental's earlier claim (under the heading "Cable is Not Telephone") that cable must be treated differently from telephone and other utilities.¹⁵⁸ Nor is Continental's analogy apt. There are no franchise fees of any kind on Continental's sample telephone and electric bills; and, as has been noted above, franchise fees are not taxes.

Continental concedes that its format is flatly inconsistent with the detailed statement of congressional intent as to itemization in the House Report.¹⁵⁹ To sidestep this clear mandate, Continental argues that the House Report is somehow rendered worthless by the fact that the Senate version of the Act (S. 12), rather than the House version (H.R. 4850), was used as the basis for the statute as enacted.¹⁶⁰ Instead, Continental wishes to rely on broad general statements made by one Senator when the amendment to Senate bill S. 12 on itemization was

¹⁵⁶ Id. at 75-76.

¹⁵⁷ Id. at 76.

¹⁵⁸ Id. at 23-26.

¹⁵⁹ Id. at 75.

¹⁶⁰ Id. at 75-76.

introduced.¹⁶¹ Continental fails to point out that the differences between the itemization provisions in the House and Senate versions of the Act, and the final provision in the Act, are minuscule and unimportant. In fact, the Conference Report notes that the version of this provision passed by the House in H.R. 4850 is "virtually identical" to the Senate version.¹⁶² In such a case, reliance on the House Report is proper.¹⁶³ Hence Continental has no basis for claiming that the House discussion is not fully applicable to the law as enacted.

2. The industry improperly characterizes the costs that may be itemized

Section 622(c) of the Act permits cable operators to itemize franchise fees, PEG channel support, and any other fees, taxes, assessments, or charges imposed by governmental authorities. Some operators, however, wish to add to these items the costs of

¹⁶¹ Id. at 76-77 & n.22 (citing 138 Cong. Rec. S569 (1992)).

¹⁶² H.R. Conf. Rep. at 84, 1992 U.S.C.C.A.N. at 1266. Other than minor changes in wording, the only difference between the two is that the House provision borrows definitions from elsewhere in the statute to define formulae for franchise fees, PEG channel services, and the like, whereas the Senate merely refers to "standards prescribed by the Commission." See H.R. 4850 section 3, amending Cable Act § 622(c)(4), 47 U.S.C. § 542(c)(4); S. 12 § 23, amending Cable Act § 622(c)(4), 47 U.S.C. § 542(c)(4). This difference does not affect the fact that such fees (however determined) must be considered part of the cable operator's rates.

¹⁶³ United States v. MacKenzie, 777 F.2d 811, 821 (2d Cir.) cert. denied, 476 U.S. 1169 (1986). It is particularly important to refer to the House Report here, because the itemization provision is absent from the original version of the Senate bill, having been added later by amendment, and thus is also absent from the Senate Report.

"local origination facilities and staffing, an institutional network, specialized municipal video services, and voice and data transmissions"¹⁶⁴ -- a list going well beyond what the statute provides. As NATOA correctly points out,¹⁶⁵ what the CPCA allows operators to itemize is the direct and documentable costs of franchise fees, PEG requirements and other fees, taxes and assessments imposed on the operator. There is no generalized right to itemize a cost merely because it relates to a franchise requirement.¹⁶⁶

In addition, according to the House Report, a cable operator may include in its itemized costs "only direct and verifiable costs."¹⁶⁷ The itemizable costs listed in the statute are direct costs with readily verifiable prices. In many cases, the industry is asking the Commission to allow it to attribute an ostensible "cost" (without any offset for revenues) to a service required by a franchise. However, by their nature, such costs are not verifiable, and hence, they cannot be itemized under Section 622(c). If operators were allowed to itemize their costs for such services, it would thus become necessary to ensure that franchising authorities and the Commission had some reliable way

¹⁶⁴Continental Comments at 78.

¹⁶⁵ NATOA Comments at 91.

¹⁶⁶ Franchises by their nature require operators to build systems and provide service. But it would be absurd to argue that all a cable operator's costs can be itemized as franchise requirements. To make any sense, Section 622(c) must be read narrowly.

¹⁶⁷ House Report at 86.

of verifying the itemized costs, to prevent operators from using creative accounting practices to inflate the cost of required services and understate the cost of direct subscriber service.

E. Small Systems Should Not Be Exempt From Regulation

The cable industry argues that all small systems should be exempt from regulation, without regard to whether the systems are owned by large MSO's, or owned by single-system operators. The Coalition disagrees.

The central theme urged by those who would exempt small systems is that rate regulation is just too burdensome for those systems. On that ground, there can be no basis for exempting small systems owned by major MSO's. NCTA argues that such an exemption is justified because the cable industry's management is so "decentralized." In fact, over the last two years, TCI customers large and small have been directly affected by programming, re-tiering and pricing decisions made not at the local level, but at the highest level of TCI's corporate offices. Most MSO-owned systems pay a substantial portion of total revenues to their parent as a management fee, a fee that would be completely unnecessary in a truly decentralized industry. The massive resources of the parent company are available to the local subsidiary. In such cases, it cannot be seriously argued that rate regulation would place an undue burden on the cable system.

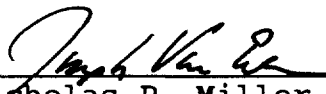
The Commission should not exempt small, independent systems either. First, subscribers in small systems deserve protection from high rates; surveys consistently show that, subscribers pay as much in small systems as is paid by subscribers in large systems, for far fewer services. Second, the amounts at stake are hardly inconsequential. In Gillette, Wyoming, slightly over 5000 subscribers received a refund of almost \$100 each to cover slightly over 15 months of overcharges. Even in communities with fewer than 1000 subscribers, a 30-50% reduction in rates could easily return \$100,000 to the community per year. Finally, communities can be expected to work with their local operator to minimize the burden on both sides. Several smaller communities already regulate rates, individually or through joint agreements, and there is no reason to assume cable rate regulation will present special problems.¹⁶⁸

¹⁶⁸In Texas, for example, it is common for smaller communities to allow larger, nearby cities to take the lead in investigating rate issues. Large communities often provide informal services to these smaller communities to assist them in regulating.

CONCLUSION

For reasons described above, the Commission should (1) reject the proposals of the cable industry; (2) adopt a proposal that provides immediate relief to consumers; (3) move toward establishment of a cost-based benchmark; and (4) otherwise adopt rules reflecting the positions outlined above.

Respectfully submitted,



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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of Section 3 of the)
Cable Television Consumer Protection)
and Competition Act of 1992)

Rate Regulation)

MM Docket No. 92-266

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February 11, 1993

**ANALYSIS OF COMMENTS TO THE FEDERAL COMMUNICATIONS
COMMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING TO
IMPLEMENT RATE REGULATION SECTIONS OF THE CABLE TELEVISION
CONSUMER PROTECTION ACT OF 1992**

(FCC 92-544; MM Docket 92-266)

February 11, 1993

Submitted by:

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About the Authors

Mr. Jay C. Smith is president of Public Knowledge, Inc., a professional firm in Portland, Oregon providing financial analysis and operations consulting services. Over the past ten years, Mr. Smith has assisted over fifty local franchise authorities with financial aspects of cable television regulation, including franchising, renewal, rate regulation, and ownership transfer proceedings. He has frequently served as an expert witness on issues relating to the economics of local cable system operations. Mr. Smith has also consulted to electric and other utility organizations on rate setting and cost allocation matters. He holds an undergraduate degree in economics and business administration and two interdisciplinary masters degrees from the University of Illinois. He has been a professional management consultant for 17 years, and is a Certified Management Consultant.

Mr. Michael Katz is the principal of KFA Services, an Edmonds, Washington firm providing financial, accounting, and economic analysis services to private and public sector clients. He frequently assists franchising authorities with cable television financial issues, and has served as an expert witness in cases involving cable system and other business economic matters. Mr. Katz has also developed cost finding and rate setting methods in other industries, including nursing homes, municipal utilities, the aerospace industry, and others. He holds an undergraduate degree in mathematics from the Massachusetts Institute of Technology (MIT), a masters degree in mathematics from Columbia University, and a masters degree in business management from MIT. Mr. Katz has been a professional management consultant for 19 years and is a Certified Management Consultant.

During the course of their work involving cable television, Mr. Katz and Mr. Smith have reviewed financial statements and financial projections for numerous local systems. They have also developed and applied cost analysis and revenue requirements models similar to the approach suggested in these comments.

ANALYSIS OF COMMENTS

1. Introduction and Summary

We have reviewed the following documents submitted in response to the Federal Communications Commission's (Commission's) Notice of Proposed Rulemaking (NPRM) on the rate regulation sections of the Cable Television Consumer Protection and Competition Act of 1992 (Act):¹

- Comments of Austin, Texas; Dayton, Ohio; Dubuque, Iowa; Gillette, Wyoming; Montgomery County, Maryland; St. Louis, Missouri; and Wadsworth, Ohio (Coalition). Submitted by Miller & Holbrooke, January 27, 1993. Includes appendices, including our own report, "Analysis of Cable Television Rate Models and Proposal for Development of Cost-Based Industry Norms" (Smith and Katz).
- Comments of the National Association of Telecommunications Officers and Advisors, National League of Cities, United States Conference of Mayors, and the National Association of Counties (NATOA, et. al.). Submitted by Arnold & Porter, January 27, 1993.
- Comments of Consumer Federation of America (CFA); January 27, 1993.
- Comments of the National Association of Broadcasters (NAB), including the appended paper, "Efficient Regulation of Basic Tier Cable Rates," by Strategic Policy Research (NAB/SPR); January 26, 1993.
- Comments of the National Cable Television Association, Inc. (NCTA), including the appended paper, "Cable Rate Regulation: A Multi-Stage Benchmark Approach," by Economists Incorporated, January 27, 1993 (NCTA/Economists Inc.).
- Comments of Continental Cablevision, Inc. (Continental). Includes appendices, including "Developing the Correct Incentive Regulation Regime for Cable Television" and "The Cost Structure for Converters, Outlets, and Installation of Equipment," by Economics and Technology, Inc. (ETI). Submitted by Cole, Raywid, and Braverman, January 27, 1993.
- Comments of Northland Communications Corporation Concerning the Notice of Proposed Rulemaking Released December 24, 1992 (Northland); submitted January 26, 1993.
- Comments of Tele-Communications, Inc. (TCI), including the appended paper, "An Analysis of Cable Television Rate Regulation," by Charles River Associates Incorporated (Charles River). Submitted by Wilkie Farr & Gallagher, January 27, 1993.
- Comments of Time Warner Entertainment Company, L.P. (Time Warner), including the appended paper, "The Economics of Cable Television Regulation," by Hatfield Associates, Inc. (Hatfield). Submitted by Fleischman & Walsh and Wilkie Farr & Gallagher, January 27, 1993.

¹ All of the submitted comments relate to MM Docket 92-266.

Having reviewed these submissions, our observations are as follows:

- There is general agreement that any rate regulation method adopted should incorporate the following elements; the method should:
 - Result in basic rates that do not exceed those that would be expected in a competitive situation
 - Use a benchmark approach
 - Be reasonably sensitive to system differences.
- There is disagreement on certain fundamental points:
 - Cost-based benchmark versus price-based benchmark
 - Method for establishing basic service rates versus rates for "cable programming services"
 - Application of system-specific cost-of-service approach
 - Method to apply in the short term
 - Basis for any "price change index."
- The cost-based benchmark model we proposed in our original submission (Smith and Katz, "Analysis of Cable Television Rate Models and Proposal for Development of Cost-Based Industry Norms") embodies the elements on which there is agreement, and appropriately resolves certain matters where there is disagreement; the model:
 - Is a benchmark method, not a system-specific cost-of-service method
 - Avoids certain accounting complexities because it applies a cash flow approach
 - Preserves appropriate incentives for efficiency, while protecting against service or quality degradation
 - Provides a sufficient return on investment to attract capital, to develop modern systems, and to maintain physical assets
 - Is administratively feasible, and potentially less burdensome than price-based approaches
 - Is fair to consumers and operators.
- Because the comments generally recognize that more data collection and analysis will be required to develop benchmarks that are flexible enough to apply over time, the Commission must develop a fair and reasonable approach for the short term:
 - There is considerable evidence of a significant monopoly component in cable prices.
 - The Commission should act to remove this component in the short term as well as in the long term.
 - We identify specific proposals for how the Commission can achieve this result.

We have also included an overview restatement of our proposed model, to provide a reference for those reviewing these comments.

2. Points of Agreement

There is general agreement on several key elements regarding rate regulation methods among the comments we reviewed, as summarized below:

Basic rates should not exceed those in a competitive situation. The comments generally recognize this goal, particularly for basic service rates. The commentators seem to agree that, in theory, this goal is achieved by rates that do not exceed costs, including a reasonable profit.²

A benchmark approach should be used. All of the comments we reviewed recommended full or partial benchmark methods, as opposed to a system-specific utility type method that would require a case-by-case full cost-of-service review in each franchise area wishing to regulate rates. The most commonly cited advantages of a benchmark approach were ease of administration and preservation of incentives for efficiency. There were substantial differences, however, in suggestions for how the benchmarks should be constructed, as discussed below.

The method should be reasonably sensitive to system differences. The commentators agree that even though rates should be guided by benchmarks, there should be adjustments to fit particular system characteristics. The adjustment factors could be addressed either on a system-specific basis, or by grouping benchmarks into broad categories that would appropriately represent the characteristics that cause costs to vary among local systems.³

3. Points of Disagreement

There was also substantial disagreement on several fundamental points among the comments we reviewed, including the following:

Cost-based benchmark versus price-based benchmark. In general, industry commentators advocated price-based benchmark approaches, whereas others recommended cost-based benchmarks. The rationale for the industry advocacy of price-based approaches (using rates, from "effective competition" areas, current rates for a cross section of systems, or historical rates as the benchmark point) appears generally to be the contention that a system-specific full cost-of-service approach would be too difficult to administer and, by allowing full cost pass throughs, would not provide efficiency incentives, so that a price-based approach is the preferable alternative.⁴ Others, including ourselves, stressed that a cost-based benchmark

² See particularly, NCTA p. 11, p. 27, p. 35, and p. 38.

³ There was substantial agreement on the kinds of factors that might be taken into account to reflect local variations, including the number of channels, system size (subscriber count), and program mix. See Northland pp. 10-18 (expressing the viewpoint of a small system operator); Hatfield, p. 21; NCTA pp. 16-17; Economists Inc. pp. 10-11; and Smith and Katz, Appendix A generally. NAB/SPR (p. 12) proposes physical system characteristics very similar to those we believe should be considered; these include the relative percentages of aerial and underground plant, whether the system is addressable, and the amount of fiber in the plant.

approach is the best way to meet the Congressional objective of establishing reasonable rates.⁵

Most commentators, including advocates of price-based approaches, recognized certain limitations in applying price-based information. For instance, most of the comments we reviewed recognized that there would be very few systems meeting the definition of "effective competition" in the Act.⁶ Consequently, those who recommended consideration of this group of systems for the benchmark generally qualified their recommendation by suggesting modifications or other alternatives.⁷ Several commentators rejected entirely a benchmark based on current rates for all systems (nearly all of which are de facto monopolies), and those who advocated that current rates be applied in some form to determine the benchmark for either basic or expanded basic rates generally acknowledged that there would have to be various "adjustments" to achieve meaningful comparability.⁸

Method for basic service versus method for "cable programming services" (expanded basic services). Most industry commentators suggested different methods for expanded basic services than for the low basic tier, generally contending either that Congress did not intend to have the same standard applied to both levels of service or that it would be undesirable to do so.⁹ However, others (ourselves included) recommended that the same method be applied to basic service and cable programming services, both to promote ease of administration and to mitigate undesirable incentives for shifting programming between tiers.¹⁰ Even industry advocates recognized that it is best not to isolate basic from cable programming services and equipment, in order to ensure an equitable overall result.¹¹

Application of system-specific cost-of-service approach. The industry advocates generally argued that a system-specific cost-of-service approach should be reserved for operators not satisfied with the benchmark results in specific situations.¹² Non-industry commentators pointed out that it seemed unfair to reserve this "safety valve" only for cable operators, and that if it were

⁴ See Charles River p. 2 and pp. 26-29, for example.

⁵ CFA p. 85; NAB/SPR p. 5 ff; Smith and Katz, entire original submission.

⁶ For instance, Charles River p. 33; NCTA p. 17; Northland p. 86; CFA p. 84; NAB/SPR p. 5; and Smith and Katz p. 4.

⁷ Industry commentators expressed a concern that certain of the "competitive systems" may price below average cost, while others were more concerned that either there may not be true competition (with the rates therefore higher than "competitive") in some of the purported competitive situations, or that multiple system operators would be able to "game the system" because they control many of the systems that are allegedly competitive (see particularly NAB/SPR).

⁸ For example, adjustments would be required to account for how equipment charges and installation costs are either bundled or not bundled into rates. Another example is the seemingly arbitrary percentile ranges that some advocated to guide application of a benchmark based on current rates charged in other systems.

⁹ Charles River p. 3, for example.

¹⁰ CFA p. 112; Smith and Katz p. 2. Although we recommend a consistent benchmarking method across tiers, we recognize that procedures for applying the benchmark may differ by tier.

¹¹ See NCTA pp. 38-39, in particular.

¹² Charles River p. 4; Continental p. 24; and Hatfield p. 22, for example.

to be an option at all, it should be equally available as an appeal basis for subscribers and franchising authorities.¹³

Method to apply in the short term. Among those commentators who felt that time would be required for the Commission to develop appropriate benchmarks, there were differences in the recommended methods to apply in the short term. The suggested methods included average prices for all systems (regulating only the "bad actors" or "renegades"), "competitive system" price benchmarks, a specific per channel price benchmark, adjustments based on pre-1986 prices, and others.

Basis for a "price change index." Those who proposed indexing approaches recommended different methods for how to adjust rates over time once an appropriate benchmark was established. The suggested indices included regional CPIs, a weighted average of an entertainment index and a general inflation index, changes in competitive system rates, and newly constructed indices.¹⁴

4. Strengths of the Proposed Cost-Based Benchmark Model

The cost-based benchmark model we proposed in our original submission (Smith and Katz, "Analysis of Cable Television Rate Models and Proposal for Development of Cost-Based Industry Norms") embodies the elements on which there is agreement, and appropriately resolves certain matters where there is disagreement. Our proposed model is similar in many respects to that proposed by the National Association of Broadcasters (Strategic Planning Research, "Efficient Regulation of Basic Tier Cable Rates").

Consistent with the position of many other commentators, the model employs a benchmark approach, is compatible with a "change index" approach, and avoids certain accounting complexities:

- Benchmark costs, rather than system-specific costs, are used for most cost elements.¹⁵ Certain system-specific exceptions can be included to make the model appropriately sensitive to significant local variations. Because the local-specific information is both used to select the appropriate benchmarks and can be applied verbatim for certain cost elements, the probability that the benchmark results will reasonably approximate the costs of each particular system is high.
- The model may be used to generate a rate change index once the appropriate benchmark level has been implemented for each system, if a rate change index is required. That is, in future periods, the Commission could run the model for a sample of systems to indicate the percentage rate changes that are warranted based on cost changes in particular sets of circumstances (possibly differing by type and size of system, by region, etc.). Programming cost changes, resulting either from changes in supplier pricing or from programming

¹³ NATOA et. al. pp. 44-46; NAB/SPR p. 7; CFA pp. 107, 110.

¹⁴ Charles River p. 34; Hatfield p. 31; Economists Inc. p. 24; and Smith and Katz p. 7.

¹⁵ NAB/SPR differs from us somewhat on this matter; the NAB proposal would benchmark capital costs, but make all operating costs local-specific.

realignments, could be directly tracked by the model. A particular strength of the model is that it balances the industry cost factors in appropriate proportion, and recognizes unit (per subscriber or per channel) cost changes that may decline over time, even as total costs may increase.¹⁶ Single factor indices and broad-based economic indices do not have this virtue.

- The model avoids certain accounting complexities because it applies a cash flow mode of analysis, as is appropriate for the cable industry. Depreciation accounting rules are not required. The revenue requirements determined by the model will provide sufficient cash to cover operating costs, replacement expenditures required for system maintenance, and a fair return on the amount of investment required to construct a modern system.

We believe that our proposed benchmark model also addresses and appropriately resolves many of the concerns expressed where there was disagreement among the commentators. Most notably, while the model is cost-based, it is not subject to many of the concerns industry advocates cited for cost-based regulation.¹⁷ Even if one assumes that the criticisms of traditional cost-based regulation are valid, the deficiencies the industry commentators typically cited for a cost-based approach are at most problems with system-specific cost-based regulation, but not with cost-based benchmarks. The model we propose:

- Preserves appropriate incentives for efficiency, while protecting against service or quality degradation
- Provides a sufficient return on investment to attract capital, to develop modern systems, and to maintain physical assets
- Is administratively feasible, and potentially less burdensome than price-based approaches
- Is fair to consumers and operators.

Each of these points is discussed below:

The model preserves appropriate incentives for efficiency, while protecting against service or quality degradation. Benchmarked costs preserve incentives for operating efficiencies at least as well as benchmarked prices. Those operators who are sufficiently efficient that their

¹⁶ For example, the cost per channel tends to fall as the number of channels increases, which is one reason why applying historical "per channel" costs or rates (when there were fewer channels on average) and extrapolating those costs or rates to the present (when there are more channels on average) will likely overstate the cost or rate that is currently appropriate. The same concern also applies to extrapolating "per channel" figures from smaller systems to larger systems at any given point in time. Certain industry advocates acknowledge the declining cost per channel (see Hatfield p. 28 for example).

¹⁷ See Charles River, p. 25, for example. It is interesting that despite the industry's general criticism of cost-based ratemaking, the NCTA and others argue that it should be made available to operators who wish to appeal benchmark rates. This seems to suggest that the industry believes that a cost-based approach is a more accurate way to set rates than the price-based benchmarks that industry advocates generally proposed.

actual costs are below the benchmark will be rewarded with additional profit. The benchmark approach will not necessarily allow operators to simply recover whatever they spend.

However, a potential problem in applying either price-based or cost-based benchmarks is that operators could cut service levels and quality to maximize the difference between actual operating costs and the benchmark. We see at least two possible controls for this potential problem:

- First, the Commission should adopt strong and enforceable customer service standards and technical standards that apply to all cable systems. Such standards would offer some protection against service cuts below acceptable levels. In addition, depending on the seriousness of the deficiency, failure to provide good service can provide a basis at the local level for imposing penalties, denying renewal, or revoking a franchise. No matter which method of rate regulation is adopted, such standards and remedies will be important.¹⁸
- Second, special procedures could be applied to programming costs. Many of the commentators stressed that the wrong kind of regulation could have undesirable programming selection consequences, and advocated that incentives for programming innovation be preserved and that undesirable retiering incentives be avoided. This objective can be achieved if one of three alternatives is applied: (1) basing the programming component of the benchmark on actual costs for each specific system, and passing these costs through into rates; (2) applying actual local channel line-ups against benchmarked costs for particular programming services, so that the full reasonable cost of programming in each system is recovered; or (3) setting a per channel benchmark standard in such a way that the total pool of identified programming costs would be sufficient to cover any mix of the available programming. Each of these approaches should preserve appropriate incentives to improve program quality and diversity of selection, and would not constrain operators' choices of programming.

The model provides a sufficient return on investment to attract capital, to develop modern systems, and to maintain physical assets. Certain commentators stated that traditional utility return-on-rate base regulation can create incentives for inefficient investment (a larger rate base provides a greater return). However, the approach we propose avoids this alleged pitfall because the rate base will be benchmarked. Those that invest efficiently so that costs are less than the benchmark will recover additional profits. Those who spend inefficiently above the benchmark will not recover a return on the full amount of their spending.

To promote desirable investment, we propose that the benchmark be based on replacement costs for specific types of systems, rather than on historical cost or net depreciated cost. This proposal helps assure that sufficient funds will be available to modernize systems. If a system is upgraded (for example, from 450 megahertz to 550 megahertz) the benchmark would be shifted to that for the upgraded system type, so upgrade incentives are inherent in the method. We also propose an

¹⁸ Possible service and quality cuts are also concerns in a non-rate-regulated situation and in a price-based benchmark environment. Consequently, strong customer service standards and technical standards are needed in these situations as well.

annual replacement cost allowance (determined as a percentage of the benchmarked system cost) to help assure that sufficient funds are available to maintain systems in satisfactory condition.

However, we do not believe that intangible "franchise value" should be included in the benchmarked base of investment. To do so would necessarily introduce a monopoly component into prices, the very thing that the Act is intended to prevent.¹⁹

The model provides a reasonable return on investment, based on a rate of return to be determined by the Commission. The rate of return may reflect the cost of capital for the industry, for the particular multiple system operator to whom it is applied, or for designated classes of operators (for instance, the Commission may find that the cost of capital is greater for small operators). The cost of capital should reflect the debt/equity mix, the actual cost of debt (interest), and an appropriate risk-adjusted return on equity. The most appropriate approach may be determined based on Commission analysis and policy.

The model is administratively feasible, and potentially less burdensome than price-based approaches. A cost-based benchmarking approach will be easy for all franchising authorities to apply, even in those cases where the franchising authority would have difficulty applying a traditional cost-of-service approach to establish rates. In effect, there will be one proceeding at the Commission level to determine the appropriate cost benchmarks, rather than hundreds or thousands of separate local proceedings. In the national proceeding the Commission will resolve issues such as the appropriate rate of return, the appropriate replacement cost allowance, et. cetera. The local information that will be required is objective, straight-forward, and readily available (the number of subscribers, for example). Because we propose the same benchmarking method for both basic rates and cable programming services (expanded basic), the Commission will not face the complexity of maintaining two or more methods, nor will it be as easy to "game" the system by shifting program tiering structures.

The model avoids the limitations and potential administrative complexities noted by many commentators for various price-based benchmark approaches, because the proposed model is not price-based, it is cost-based. For example, the concern that several industry advocates expressed that the rates charged by certain competitive systems could be below average costs would not be an issue. Nor would the possible "gaming" of rates in the benchmark systems noted by other commentators be a problem. To the extent that data for competitive systems could be one source of possible input for developing norms, for instance, the data used would be cost information, not rate information. The cost information would be more stable and not as subject to fluctuation attributable to marketing strategies or "gaming."

Because the model we propose reasonably reflects costs and is reasonably sensitive to local variances, it will simplify the administrative process. The number of complaints or appeals the Commission receives, and the time required to address those complaints or appeals, will be

¹⁹ See also NAB/SPR pp. 7-8. The one industry submission that we reviewed which spoke to this matter, Continental's, provides a discussion consistent with our own view that the monopoly "franchise value" is the largest component of cable intangible assets. However, Continental asserts that intangible "franchise operating rights" belong in the rate base (Continental Appendix B pp. 3-5). We disagree on this point.

minimized. By contrast, the price-based approaches proposed by industry proponents could be administratively complex. Under the industry proposals, several different proceedings could be necessary to analyze rate increases. These would include the initial Commission data collection and analysis to set the benchmarks, proceedings to adjust the benchmarks to specific local circumstances, the application of separate methods/proceedings for basic versus expanded basic rates, and the likelihood of supplementary proceedings. Supplementary proceedings (which industry advocates suggest should be full system-specific cost-of-service proceedings) would be frequently required because of the inherent inaccuracy of using prices to benchmark variations in costs in an industry that is predominantly de facto monopolies.

To help develop and implement the model we propose, the Commission would conduct a cost survey of a cross section of systems nationally, including certain stratified sub-samples (such as "effective competition" systems). Simple forms would be sent to the operators of the systems selected in the sample. The operators would be asked to fill in certain cost and statistical information for the specified systems. The information requested would be readily extractable from the accounting and other records typically maintained in the industry. A uniform chart of accounts is not required.²⁰ Operators would be allowed to respond in a manner that is compatible with their own accounting systems. For example, if operating revenue and expense information is not maintained on a system basis, but rather for groups of systems, the operator could respond with group level data.²¹ Balance sheet data, depreciation information, interest expense data, and income tax information would not be required in this survey.²²

We do not believe that the cost survey process would be onerous for operators. Indeed, many industries including, we believe, the cable industry, conduct periodic cost surveys to develop benchmark cost information that is then shared among survey participants. Uniform charts of accounts have not been required to obtain meaningful results. The survey would be no longer than that already used by the Commission in this proceeding. The information sought would be less extensive than the information many communities already require of their operators (either

²⁰ We believe that those industry advocates who cite the lack of a uniform chart of accounts as a reason not to apply a cost-based approach are incorrect on this matter (see NCTA p. 27; Economists Inc. p. 15; and Hatfield p. 33, for example). A uniform chart is not required because the types of costs and the level of detail that the benchmark survey would need to identify would be readily identifiable from accounting records regardless of the chart of account detail, given accounting systems meeting at least minimum standards. In fact, one of the industry proposals for regulating equipment and installation rates, "The Cost Structure for Converters...", applies cost data and indicates that "... the methodology is not sensitive to differences in accounting categories" (Continental/ETI Appendix D p. 1).

²¹ See Continental p. 36, for example. Continental also recognizes that a benchmark approach does not require uniform accounting rules (p. 27). A possible exception where survey cost data may be required on a franchise or system-specific basis, rather than a group basis, would be for the survey sub-sample targeted for those systems in "effective competition."

²² The two submissions which addressed the issue, our own and Continental's, suggested that a cash flow approach is a more appropriate mode of financial analysis for the cable industry than is the return-on-rate-base approach traditionally applied in utility regulation (Continental p. 24; ETI, "Developing the Correct Incentive Regulation...", p. 5 ff.). Detailed depreciation accounting is not required for cash flow analysis.